

Risky, Ill-Timed Land Deals Hit Calpers

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At the height of the property bubble, California's giant pension fund, Calpers, made a fateful decision: It aggressively poured money into real estate. As a result, today it's one of the biggest owners of undeveloped residential land in America.

Bad Bets

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See more details on some of Calpers's real-estate investments.

Partly because of these investments, California Public Employees' Retirement System is struggling to avoid one of its worst annual declines since its 1932 inception. Calpers has lost almost a quarter of its assets since July 1, the start of the current fiscal year.

The problems come at a time of uncertainty for the nation's largest public pension fund, which has been without its top two executives for nearly half a year. Calpers is poised to appoint a new chief executive as early as this week, people familiar with the matter said.

Calpers is now warning California's cities, towns and schools that they may have to cough up more money to cover the retirement and other benefits the fund provides for 1.6 million state workers. Some towns are already cutting municipal services, and at least one is partly blaming the Calpers fees.

Calpers in recent weeks said it expects to report paper losses of 103% on its housing investments in the fiscal year ended June 30. That's because Calpers invested not only its own money, but billions of dollars of borrowed money that must be repaid even if the investment fails. In some deals, as much as 80% of the money invested by Calpers was borrowed.

In the latest wrinkle: To generate sorely needed cash, a troubled Calpers venture known as LandSource recently started the process of selling land during the worst property market in a generation. Calpers could potentially lose nearly \$1 billion on LandSource, a \$2.5 billion deal

completed early last year, and one of the priciest U.S. residential-land transactions ever. LandSource is now under bankruptcy-court protection.

With \$239 billion in assets as of June, Calpers's portfolio was bigger than the government-run funds of Russia, South Korea, Dubai and Chile combined. In recent years, Calpers became much more aggressive than other pension funds in making nontraditional investments -- real estate, foreign stocks, even forestland.

Unless Calpers's returns bounce back by June, the fund says it expects that the rates it charges governments to participate in the pension could rise starting in 2010, leaving them with less money to spend on other services.

Alicia Munnell of the Center for Retirement Research, Boston College, says the economic slump will likely force other pension funds besides Calpers to pass on the financial pain. "Even under the best-case scenario...taxpayers are still going to have to put more money into pension funds."

Calpers points out that its commercial properties, including a chunk of Time Warner Center in New York, haven't been nearly as hard-hit as residential investments, which are valued at about \$6 billion. Together, residential and commercial holdings total about one-tenth of the fund's overall \$182.6 billion portfolio. Its real-estate portfolio fell 14.4% for the 12 months ended in September, underperforming its benchmark, which rose 5.3%.

Calpers stresses that it's a long-term investor and can earn back the declines in the future, just as it erased declines suffered in the dot-com bust a few years ago. "No one in the marketplace knew how swiftly the housing market would fall -- not the Federal Reserve, not the Treasury," said Ted Eliopoulos, head of Calpers's real-estate portfolio, in an interview.

The fund has also added "checks and balances" on property-investment decisions, Mr. Eliopoulos said. "Calpers has always attempted to learn from downturns," he said.

The details of Calpers's housing deals, and the identities of some of the home builders it invested with, are only starting to come to light. That's because investments were often made through ventures with opaque names like "Hearthstone Path of Growth Fund," and Calpers doesn't detail many of their holdings.

Calpers says its investments were done with "customary oversight" and were "appropriate for the asset class and typical the industry."

In recent years Calpers invested in:

Three large parcels near Phoenix, one of the nation's hardest-hit property markets. Last month, Calpers effectively walked away from one of the three, after having invested \$140 million. On one of the others, to start earning a return, Calpers's investment partner recently started selling ground water from the property.

A massive block of land with room for about 8,000 units near the small town of Mountain House, Calif., the nation's most "underwater" housing market by one measure. (Nearly 90% of homeowners there owe more on their mortgages than their homes are worth, according to mortgage-research firm FirstAmerican Corelogic.) As of June 30, Calpers valued the investment at negative \$305 million, reflecting the fact that it has repaid borrowed money used in the deal.

About 10,000 acres near Jacksonville, Fla. The plan was to sell timber from the property, as well as residential lots. But as real estate collapses, it could take five years before the venture can start selling lots.

Just one particularly bad year for investments can have serious consequences for California governments in the retirement system. Calpers recently estimated that if its declines for the current fiscal year are greater than 20%, it would trigger an increase of 2% to 5% of an employer's payroll.

Currently, the average employer-contribution rate for public agencies, including cities and counties, is 13% of payroll, Calpers said, which is already on the high side for state pension funds, according to industry analysts. A 5% increase in California's rate would be the largest increase to hit public employers since the dot-com bust.

Any rate increases aren't a certainty, Calpers says, since the fund could still earn back its declines.

Real-estate losses aren't the primary reason Calpers is taking a hit. Its biggest declines have been in the stock market: Its stock portfolio is down 41% so far this fiscal year.

But Calpers has targeted less money in bonds, and about double the allocation to private-equity investments and real-estate deals, than the average public pension fund, according to Calpers documents and an industry survey.

Calpers got more aggressive in real estate amid the tech-stock selloff of 2000-02. Its board decided to increase its investments in real estate and private equity, shifting some money out of safer, but lower-yielding, holdings like bonds.

Robert Carlson, a former Calpers board member who left the board earlier this year, said publicly at that time, "We believe taking no risk is the biggest risk you can take."

Land purchases are among the riskiest real-estate investments. Not only can property values swing wildly, but unlike, say, a stock, land can take months or years to sell. Amplifying the risk, many of Calpers's land investments used borrowed money.

Investing borrowed money acts as a lever: In a rising market, it lifts overall returns since you're profiting not only on your own capital, but the borrowed money too. But in a falling market, that leverage amplifies losses.

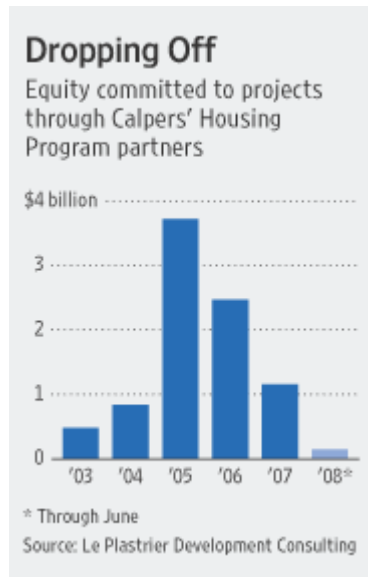
To help it identify promising real-estate investments, Calpers turned to a small circle of partners it had previously done deals with since 1992, albeit on a much smaller scale.

"The early investments had worked very well," says Barry Gross, president of Developers Research, an Irvine, Calif., advisory firm that had consulted on several earlier and smaller Calpers land investments. "Calpers said, 'If we can do it with 300 houses, let's do it with 3,000.'"

Michael McCook, then head of Calpers's real-estate investments, proposed boosting returns by investing more borrowed money. "I told them it would help in the good times, and it would hurt in the bad times," Mr. McCook recalls telling the board in 2002.

Investing borrowed money is common in land-buying partnerships. Mr. McCook says he felt Calpers would be at a disadvantage when vying for a piece of these deals if it were unwilling to boost returns in a similar way.

Calpers already used borrowed money in commercial-property deals. Between 2001 and 2002, it raised the amount permitted to an average 50% from 25%.



In residential-property deals, traditionally Calpers hadn't used much borrowed money. But in 2005, the trustees sanctioned use of borrowed money in residential deals at an average rate of 60%.

Since the average rate applies to Calpers's entire housing portfolio, some individual deals used as much as 80% borrowed money, Mr. McCook recalls. That level is more aggressive than many pension funds or land developers would use, industry consultants and developers say.

Calpers says that other public pension funds have invested borrowed money at the same level.

The increased use of borrowed money corresponded with the peaking property market. In 2004 and 2005, housing prices were jumping as much as 30% a year in some places.

Until last year, the Calpers strategy worked. Through its housing partners, the fund pursued big, complex deals with large home builders. Returns on housing investments were an impressive 16% average annually from 2004 through 2006.

In a typical deal, Calpers would provide the funding to its partners, who would team up with a home builder to buy land. Most of the equity would come from Calpers, while the home builder would put down 10% to 15%, in exchange for the right to eventually buy the land in full.

Home builders like to do this because it lets them essentially control land without having it weigh down their balance sheets. And Calpers hoped for big returns by selling that land to the builders in a booming market.

Calpers's investment partners worked with major home builders including [Hovnanian Enterprises Inc.](#) and [Beazer Homes USA](#), according to two people familiar with the matter.

As the property market soured, deals that once looked smart revealed a dark side, because Calpers agreed to terms that exposed it to more of the risk in bad times.

For instance, Calpers guaranteed \$1.7 billion in debt across several deals. Typically, home-builders are the guarantors -- that is, they're on the hook in the event of a default.

By being guarantor, Calpers used its rock-solid reputation to obtain lower borrowing costs. But today, as projects struggle, the guarantees mean Calpers is pouring additional cash into projects from which it might otherwise prefer to walk away.

As the U.S. property market crested, the deals got bigger. The biggest was LandSource, the \$2.5 billion venture now in bankruptcy-court protection.

In LandSource, Calpers teamed up with [Lennar](#) Corp., the giant Miami-based home builder. Lennar was known in the industry for its sophisticated use of land deals.

The LandSource deal took shape in 2006, when Victor MacFarlane, one of Calpers's long-time real-estate investors, asked Lennar if it would be interested in selling a big stake in its 15,000-acre Newhall Ranch, north of Los Angeles.

Newhall Ranch's co-owners, Lennar and LNR Property Corp., a unit of Cerberus Capital, were willing to sell. Around the same time, Lennar's CEO, Stuart Miller, was warning that the weak housing market could worsen. Discussing land purchases in a September 2006 conference call, Mr. Miller said: "Right now there's no evidence of opportunities to jump in and buy something strategic."

The LandSource deal involved \$970 million from a Calpers-funded venture, along with \$1.5 billion in borrowed money. Lennar and LNR each received \$707 million in cash and each retain a 16% stake. The Calpers-venture, which was co-managed by Mr. MacFarlane's firm and Weyerhaeuser Realty Investors, a unit of the giant timber company, took a 68% stake.

Mr. MacFarlane, the man proposing the deal, was highly regarded among Calpers top brass. "Victor MacFarlane was well-known and liked by board members and the CEO," says Russell Read, then Calpers's chief investment officer, who stepped down in June and now heads C Change Investments, which invests in companies that promote new technologies for protecting the environment.

Mr. Read takes responsibility for giving LandSource the go-ahead at Calpers. "We based it on our research, our judgment and on MacFarlane's track record," he says.

It turned out to be a bad moment to buy land. In the summer of 2007, just a few months after LandSource closed, the U.S. housing market entered its historic free-fall.

LandSource filed for bankruptcy protection earlier this year.

Mr. MacFarlane declined to comment. Previously, he has said he knew the market was in decline but viewed LandSource as a long-term investment that would pay off over a decade or more. A Calpers spokeswoman said in recent days, "We are monitoring [LandSource] in the bankruptcy process and protecting our interest." A lawyer for LandSource says the venture is planning to sell smaller parcels, but preserve the large Newhall Ranch.

Amid the losses, Calpers is making some changes in its investment-decision process. In February 2007, shortly after Mr. Eliopoulos became head of Calpers' real-estate group, the fund set a new policy requiring deals to be vetted three times -- by the internal investment committee, an independent fiduciary and, finally, by an outside consultant. Previously, much of the oversight came from Calpers' staff and consultants.

Calpers is creating a new computer database to more closely track "balance and diversification" in the real-estate portfolio. It also is proposing to reduce the maximum amount of borrowed money that can be used in housing deals, and cut back on loan guarantees.

George Diehr, vice-president of Calpers' board, said that in the future the fund will have less of its money invested in residential property, although that's partly because its current holdings have fallen in value.

"Certainly, there remains a possibility that additional properties will be sold," he said. "We're doing the analysis now."